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OF

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1949.

Nos. 761-762

IN THE MATTER OF
FRANKLIN BUILDING COMPANY,
Debtor.

JOHN W. EMMERLING, TRUSTEE OF FRANKLIN BUILDING COMPANY,
Petitioner,
vs.
ROBERT W. SCHROEDER,
Respondent.

JOHN W. EMMERLING, TRUSTEE OF FRANKLIN BUILDING COMPANY,
Petitioner,
vs.
MOLLIE SCHROEDER AND JUNE KUPTZ,
Respondents.

REPLY BRIEF OF PETITIONER

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ARGUMENT

The divisions of the brief of respondents in opposition to Petition for Certiorari correspond to those in the brief in support of the petition except that parts II and III of the latter are both discussed in part II of the former. The divisions of this reply brief adopt the organization of respondent's brief.

I.

MANUFACTURERS TRUST COMPANY v. BECKER DOES NOT GOVERN THIS CASE

Part I of respondents' brief is devoted to a discussion of part I of petitioner's brief. The argument made depends almost entirely upon *Manufacturers Trust Company v. Becker,* 338 U.S. 304 (1949), and is in general based upon the proposition that that case governs this case. Counsel for respondents concedes that this case involves the same question of law which was left undecided in the *Becker* case, namely, whether the claims of close relatives of a fiduciary should be limited to cost when it appears that the fiduciary purchased their bonds for them either pursuant to a joint enterprise in which he and they participated or as their agent acting under broad express authority. However, it is contended that the *Becker* case now establishes that the conduct of the fiduciary himself was proper, and that therefore this question should again be left undecided in this case.

It is submitted that the *Becker* case does not govern this case as to the points for which counsel cites it because the undisputed material facts in this case are substantially different from those in that case; and, further, because this Court was very careful in its decision to prevent extension of the principles laid down to situations like that in the case at bar. (It should also be pointed out that the conduct of this particular fiduciary, William A. Schroeder, was held by the District Court to be improper (R. 177), and his claim was limited as to his own bonds (R. 183-185); there has been no appeal from that determination. The only question remaining here is whether the result can be different as to his wife, son, and daughter.)

Both the District Court (R. 177) and the Court of Appeals (R. 206) considered that there was applicable to the fiduciaries in this case the rule of *Magruder v. Drury*, 235 U.S. 106 (1914), that a trustee shall not be allowed to profit from his trust. In that respect both courts were clearly correct, as this case does involve an express trust which was created by the Trust Agreement (Ex. 3) under which the Bondholders Committee operated the debtor's business for some fifteen years. William A. Schroeder, as the managing agent employed by the committee, was of course also a fiduciary and subject to the same rule of law, as the District Court ruled. Therein lies one of the important distinctions between the *Becker* case and this case; for in that case the persons involved were not trustees of an express trust, but director of a going business, and this Court accordingly expressly held that the rule of *Magruder v. Drury* was inapplicable.

Another distinction between the *Becker* case and this case is implicit in the great differences in the financial condition of the two debtor corporations. Counsel for respondent states that the opinion in that case "made it clear that the status of the corporation as a going concern is a matter of much importance in the consideration of fiduciary duties" (Br. 10). As a matter of fact, his statement might have been made more positively; for it is clear from the opinion that the result would have been different if the debtor in that case had not been a going concern at the time the securities in question were purchased. Furthermore, in the concluding paragraph of the opinion this Court clearly implied that it might well have reached a different conclusion "if in fact liquidation had been imminent at the time of respondents' purchases". Thus, the *Becker* case might be summarized as holding (as to corporate directors) that in the typical case of a

corporation which was at one time solvent, which has become insolvent but remains a going concern, and the financial condition of which is progressively becoming poorer so that it is becoming less and less a going concern and more and more a prospective subject for judicial relief, the directors may trade in its securities even after it becomes insolvent provided that it remains a going concern; but there is no implication that they may do so after the corporation has become so little a going concern and so much a prospective subject for judicial relief that a conflict of interests would arise from their purchases, or after liquidation has become imminent.

Here there is presented the case of a corporation which never even became a going concern—a corporation which was operated by trustees for the benefit of its creditors for a period of some 15 years before it even became a prospective subject for judicial relief—a corporation the liquidation of which was imminent, or at least a clear and present danger, during all of the years from 1932 to 1947. The facts as to the financial condition of this corporation are summarized at pages 8 through 14 in the statement of the case of the brief in support of the petition for certiorari. They show that Franklin Building Company never even completed the building which it was formed to erect; that within a few years after it commenced doing business it had defaulted on its bond issues, and as a result one bondholder had in 1932 brought action upon his bonds and tied up all of the income of the company by garnishment; that thereafter the business was operated at a loss during each and every year, including 1947; that finally in that year the condition of the company had *improved* sufficiently to make it a subject for judicial relief by way of reorganization.

These facts are the reverse of the facts in the *Becker* case. These facts make it clear that a conflict of interests was necessarily created whenever any of the fiduciaries operating the company for its creditors traded in its securities. Counsel seeks to draw a parallel between the cases, and to make the condition of this company appear sound, by referring to the payment of back taxes and the completion of the building "out of current earnings alone" (Br. 10); but the fact remains that there were no net earnings when the interest due to the bondholders is taken into account. Actually, what in effect happened during the years from 1932 to 1947 was that the bondholders devoted money that was due them as interest to the payment of those old obligations of the company, which can hardly be called the normal way of operating a going business. The deficit account of the company's business increased every single year by the amount of the net loss shown in the table on page 12 of the brief in support of the petition, and every penny of those losses came out of the pockets of the bondholders. That being the case, at every instant for a period of fifteen years there was before the persons in control of debtor's business the question of whether it was better to continue operations or to liquidate the assets. True, progress was made in reducing certain other obligations; but were the bondholders better off at the end of 1939, for instance, than at the beginning of that year, when all that was accomplished in the interim was reducing delinquent taxes by $5,500 while they lost nearly three times as much in interest? It would not be fair to judge the value of the committee's efforts by the use of "hindsight"; but questions such as that clearly demonstrate that a conflict of interests was created whenever one of the persons in charge of debtor's affairs traded in its securities during those years.

Counsel recognizes that in the *Becker* case this court paid attention to the rule enforced in the lower Federal courts, that a fiduciary may not purchase securities of the debtor corporation "after judicial proceedings for the relief of a debtor are expected or have been begun" (Br. 11-12). He seeks to avoid this rule upon the ground that the 1943-1947 reorganization proceedings, which were pending while nearly all of the bonds of these respondents were purchased, were not brought in good faith and were "a part of the very program of wrecking the debtor corporation" which he attributes to certain sinister persons. This rule of the lower Federal courts, of course, contains no exception as to proceedings instituted by persons whose opinions may be different from those of the persons in control of the debtor; instead, it is grounded upon the necessity of preserving the integrity and loyalty of persons who are in charge of a corporation which is in the custody of the court. Considerations such as this, going to the very basis of the control of a court over its proceedings, should not be cast aside because of the identity of the persons who institute those proceedings.

Furthermore, counsel's reasoning does not go far enough in this case. He makes mention of the fact that Robert Schroeder purchased the bonds of the plaintiffs in the 1943-1947 proceedings, but he does not mention the fact that that purchase occurred on February 25, 1946. There is not much reason for supposing that those persons were very dangerous thereafter, and in fact there is no reason whatever for not applying the rule to the bonds of these respondents which were purchased on and after that date and which amount to 86% of their total purchases during the years 1943-1947 (see table, pp. 14-16, brief in support of petition).

In view of these considerations and particularly in light of the care which this court took in framing its opinion in the *Becker* case in such a way that it would not be extended to other and different cases, it is submitted that that decision does not in any way justify William Schroeder's conduct in trading in the securities of his trust for the benefit of his family. Rather, this case is of the type this Court had in mind which it stated that it "has recognized that equity must apply not only the doctrines of unjust enrichment when fiduciaries have yielded to the temptation of self-interest but also a standard of loyalty which will prevent a conflict of interests from arising." No such standard has been applied in this case; a conflict of interests did arise when William Schroeder traded in debtor's bonds; and it is accordingly submitted that the decision in the *Becker* case cannot in any way be said to approve of conduct like that of the husband and father of these respondents.

II.

THE DECISION IN THIS CASE CANNOT BE RECONCILED WITH THE CITED DECISIONS OF THE COURTS OF APPEALS FOR THE SECOND, THIRD, AND SIXTH CIRCUITS

In Part II of respondents' brief an attempt is made to reconcile the decision of the Court of Appeals for the Seventh Circuit in this case with the decisions for the Courts of Appeals for the Second and Sixth Circuits discussed in Part II of the brief in support of the petition and with the decision of the Court of Appeals for the Third Circuit discussed in Part III of the brief in support of the petition. It is stated that no conflicts whatever exist between the decision in this case on the one hand and the decisions in those cases on the other hand.

Irving Trust Co.v. Deutsch, 73 F. (2d) 121 (C.C.A. 2, 1934), cert. den *sub nom. Bell v. Irving Trust Co.,* 294 U.S. 709, followed the rule that "one who knowingly joins a fiduciary in an enterprise where the personal interest of the latter is or may be antagonistic to his trust becomes jointly and severally liable with him for the benefits of the enterprise" (73 F. (2d) at p. 125). The argument made to reconcile that principle with this case is "that the petitioner assumes that the respondents were engaged with William A. Schroeder in a joint enterprise and that they knowingly joined with him, a fiduciary, in breaches of his trust", and that such "assumption begs the whole question." The question begged is said to be "whether the purchases of bonds by the respondents constituted a violation of the duty of a fiduciary" (Br. 16).

It is submitted that in advancing this argument counsel for the respondents misconceives both the rule of the *Irving Trust Co.* case and the position of the petitioner. That case did not require that the purchases constitute breaches of trust, but simply that they involve a situation in which "the personal interest of the latter [fiduciary] is or may be antagonistic to his trust". It would seem to be beyond dispute that when a trustee purchases securities for himself and for members of his family, deciding among them as to who shall be the ultimate owners of the bonds simply on the basis of "who had too much cash" (R. 112), his personal interest is or may be antagonistic to his trust.

But in any event the purchases were not purchases "by the respondents". Let there be no mistake about the fact that William A. Schroeder bought these bonds for these respondents, as all of the evidence makes perfectly plain (R. 55, 57-58, 62-63, 65, 68-72, 71, 96-97, 100). And his purchases of their bonds for the respondents were

breaches of his trust to exactly the same extent that his purchases of his own bonds were. Counsel states that no authority is cited for that proposition; but attention is called to the authorities on page 25 of the brief in support of the petition, which are referred to in a footnote at the very beginning of the argument on this point on page 30.

Therefore, whether these purchases be regarded as breaches of trust or simply as transactions in which William Schroeder's personal interest was or may have been antagonistic to his trust, they are squarely within the rule of *Irving Trust Co. v. Deutsch* and approval of them is in conflict with the decision in that case.

At page 17 of the brief it is asserted that the *Becker* case "is a square holding" to the effect that a fiduciary who is not allowed to purchase bonds for himself nevertheless is permitted to act as agent for others in purchasing bonds for them. In fact the *Becker* case held no such thing, for the court concluded that the purchases of the fiduciaries for themselves were proper and therefore said "it becomes unnecessary to determine whether the relation of the Becker respondents to the directors was such as to require limitation of these respondents' claims * * * " (footnote 16).

Counsel also takes issue with characterizing the operations of the Schroeder family as a joint enterprise (Br. 18-19), which, as was pointed out in the argument in support of the petition (pp. 26-27) need not be established in view of the undisputed principal-agent relationship. But the attempt to disprove the joint enterprise consists simply of emphasizing the *present* occupations and places of abode of Robert Schroeder and June Kuptz and attempting to show that the four people were all

individuals, which of course is always true by definition of the members of a joint enterprise.

Counsel also says that this case is entirely different from *In re Van Sweringen Co.*, 119 F. (2d) 231 (C.C.A. 6, 1941), cert den *sub nom. Terminal & Shaker Heights Realty Co. v. Van Sweringen Co.*, 314 U.S. 671, which is in accord with the *Irving Trust Co.* case, but cites no reason why the principle of that case should not have been applied in this case.

The same is true of the case as to Section 249 of the Bankruptcy Act discussed in Part III of petitioner's brief, *In re Midland United Co.*, 159 F. (2d) 340 (C.C.A. 3, 1947). Aside from pointing out the differences in the wording of Sections 212 and 249, counsel makes no argument in opposition to the reasons cited in the brief in support of the petition which show why those two sections should be construed in the same way.

CONCLUSION

The respondents take no issue with the position of the petitioner that this case presents a question which (a) has great importance in the administration of the Bankruptcy Act; (b) should be finally settled by this Court; and (c) has been decided by the Court of Appeals for the Seventh Circuit in a way which is inconsistent with the governing principles laid down by this Court. Instead, the attempt is to demonstrate that this question need not be decided at all because of a lot of altruistic motives which are ascribed to respondents, to a large extent without support in the Record. This is not an appropriate stage of the proceedings at which to analyze the evidence as to their state of mind. It is sufficient to point out that the question remains regard-

less of respondents' motives, and drawing attention to those merely adds to the main question a secondary one, namely, whether motives are material.

The respondents do attempt to reconcile the decision in this case with contrary decisions of other Courts of Appeals; but this effort again is largely devoted to arguing that the principles of those cases have no application to this case because these claimants were engaged in thwarting the evil purposes of certain sinister "outsiders", although those persons were also bondholders and no reason is suggested why the District Court would not be able to safeguard the interests of all parties in the reorganization proceedings which they instituted.

Essentially this case presents but one question, regardless of the attempts made to give it a different appearance. That question is whether a fiduciary can, pursuant to plan, benefit members of his immediate family by purchasing for them the securities of his trust, when he is forbidden to do the same thing for himself. That question merits final determination by this Court, and the petition should accordingly be granted.

Dated at Milwaukee, Wisconsin, May 19, 1950.

Respectfully submitted,

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